The finance of IP litigation

As contingency arrangements in US patent cases become rarer, litigation financing options are attracting more interest. With so many choices available, those exploring opportunities have much to understand

By Fatih Ozluturk

Patents are expensive. They are expensive to apply for, expensive to prosecute and expensive to maintain. Companies with large patent portfolios must also keep tabs on what patents they have and why they have them, which requires staff and corporate infrastructure. However, by far the most significant expense associated with deriving value from patents is that of enforcing them.

A district court case involving a few patents can cost from $5 million to $10 million, accounting for full attorney fees and other hard costs such as expert fees. A patent infringement case at the International Trade Commission will cost at least $10 million. This is an expense that many companies cannot afford. These facts apply not only to patents, but also to the creation and protection of other forms of intellectual property.

Full contingency law firms used to provide an avenue for rights holders needing to enforce their rights but lacking the resources to pay the full hourly rates of a litigation firm. However, that path is now largely closed – particularly for patents – due to the increased challenges and higher risks associated with litigation following the America Invents Act and several important Supreme Court and Federal Circuit decisions. There are few full contingency firms left and they certainly do not wish to pay for hard costs, which can reach between $1 million and $2 million – sometimes more.

This is where litigation funding comes in. Once an esoteric variety of investment undertaken by adventurous investors, litigation funding is now a well-established, necessary part of the IP ecosystem. When practised by the more sophisticated entities in the space, it is a rigorous and specialised process that produces term sheets in line with the specific risk associated with each case. Thus, IP litigation funding offers an avenue for patent holders to share the risk and cost of litigation. Patent holders can compare term sheets from different funders to find an option that suits them.

In its typical form, litigation funding involves deploying capital to the patent holder or to the law firm. Where there is a recovery, the funder is compensated through the proceeds received by the patent holder or the law firm. A graphical representation of how the funds flow in IP litigation funding is shown in Figure 1.

Although litigation funding creates options for patent holders, it also presents a number of challenges, irrespective of whether the rights holder is a large corporation, a research university or an individual inventor. The reason for this is that the established conventions that are understood by parties on both sides of a transaction in more traditional financing deals do not exist in IP litigation funding. More importantly, assessing risk in IP cases is generally complicated and subjective. This fact alone makes IP litigation funding a difficult endeavour for everyone involved. A better understanding of the underlying principles and parameters in such deals can help to remove some of the mystery and begin to make these investments easier to analyse.

IP litigation funding comes in many flavours

Litigation funding can generally be structured as equity or credit (ie, debt) investments). Equity investments give the funder a share of the upside but any claim that it has on the underlying assets is subordinate to other investors or is simply unsecured. Just like buying common stock, in the case of non-recourse litigation funding, if the underlying asset – in this case the claim asserted in IP litigation – loses its value, the investor loses the invested capital.

On the other hand, in the case of secured credit financing there may be recourse, as the lender may require the debt to be secured not only by the claim in the underlying IP litigation but also by additional assets. In many cases, credit financing in IP litigation is secured by other patents of the borrower that are not in litigation. All else being equal, an equity-type investment should result in a higher cost of capital than secured credit financing would, simply because the risk in credit financing is lower thanks to the investment being secured by other assets.

Figure 2 shows how the cost of capital generally changes from one type of litigation funding arrangement to another from the perspective of the rights holder. The type of investment options listed in Figure 2 overlap and may move up and down the scale depending on the actual terms.

Reflecting the diversity of approaches in the space, a patent claim holder seeking funding could see as many different term sheets as there are funders. No two term sheets will be identical. In the end, the difficulty for the patent holder is having to compare term sheets, which requires an understanding of the basic financial constructs used to evaluate such proposals.

General due diligence in IP litigation funding

Having mentioned the types of funding options available to rights holders, it may be helpful to describe the general process that a rights holder should expect when seeking litigation funding. This typically has many of the same steps, regardless of the type of funding being sought.

Initial funnel

This is the step where the funder eliminates most of the incoming cases based on a few key parameters. Funders will want to know high-level facts about the IP litigation – whether there is a law firm in place, the size of damages or settlement range, the story behind the case, the general topic to which the intellectual property relates and the potential defendants. In patent cases, many funders also eliminate cases involving patents with excessive *Alice* risk at this stage – in other words, patents that cover subject matter that may not be patent eligible any longer based on the US Supreme Court's 2014 decision in *Alice Corp v CLS Bank*. Rights holders would be well served to write short answers to these types of question ahead of time.

> *"Many funders also eliminate cases involving … patents that cover subject matter that may not be patent eligible any longer based on the US Supreme Court's 2014 decision in* Alice Corp v CLS Bank*"*

It is also important for the patent holder to show that there is a sizable recovery potential – hence that there will be a large enough return for it, the firm and the funder when the pie is split. Funding firms that do their own diligence in-house complete the initial funnel evaluation fairly quickly.

First level due diligence

This is a more in-depth due-diligence process, whereby the funder assesses whether it will issue a term sheet to the rights holder. The goals at this stage are to determine whether there are any red flags to indicate that the case is not a good fit and to examine the financial parameters to gauge whether certain returns are possible under the baseline assumptions.

For patent cases, a funder will look at the claim charts in detail, review any validity search which has been carried out or undertake its own searches, review patent prosecution histories and determine a reasonable range for damages. The best advice for the rights holder at this stage is to have documentation such as the claim charts ready for review, and to provide timely answers to questions that arise along the way. It is vital for the rights holder to present the relevant facts, whether they are favourable or not.

Term sheet

Following the first level due diligence, many funders present a term sheet reflecting their assessment of the case. Other funders will present a term sheet earlier or later in the process. If a term sheet is presented earlier than this point in the process, one should be wary. A term sheet that is not based on the specifics of the case – which are revealed only after some level of due diligence – is likely to treat each case as being extremely risky and will likely have a high capital cost.

Detailed due diligence

This is the stage where the funder may spend substantial time, effort and money to carry out deep due diligence on the case, including extensive invalidity searching. Because of the larger resource commitment and the opportunity cost of not being able to dedicate time to other cases in the pipeline, a funder will generally embark on this deep due diligence only after the term sheet is agreed and an exclusivity period is granted by the rights holder.

The funding agreement is then signed and the funds are made available, unless the detailed due diligence reveals facts that are contrary to the assumptions and the representations made by the rights holder in earlier stages. It is important for the rights holder to recognise that the funder is working hard to put together an investment proposal for the funding firm's internal approval. It is therefore in its best interests to assist the funder to make the most complete presentation internally. Being open with information and treating the funder as a partner always pays dividends.

FIGURE 1. IP litigation funding fund flows

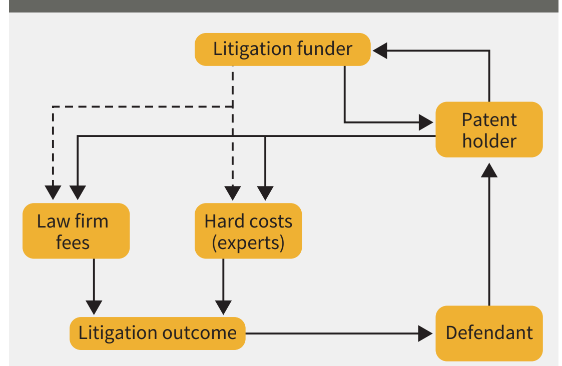

FIGURE 2. Types of litigation funding investment

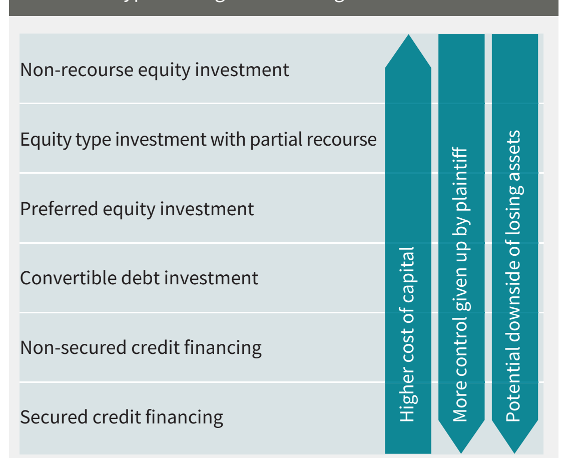

Figure 3 presents a summary of the process and the best way for a rights holder to help to move the process forward. Rights holders should expect the entire funding timeline to take six weeks or longer, sometimes much longer, depending on the complexity of the case.

Evaluating funding term sheets

Given the recent influx of investor money into the space, IP litigation funding is now practised by entities with different approaches and business practices. Often the fundamental terms of deals remain opaque. To illustrate the point, consider mortgage lending, where the deal terms are generally transparent. All large banks would offer you similar mortgage rates and have a similar application process. Even if you do not shop around, you can be fairly confident that you are not paying much more than the next borrower. Not so in IP litigation funding: term sheets are not made public, they are not posted on websites and there is no visibility into what someone else has paid to fund their case. This is a huge disadvantage for rights holders as they do not have the benefit of knowing the true market rates. The best way for a rights holder to cope with this asymmetry of information is to work with reputable funders, aim to receive multiple term sheets and know how to evaluate these, even when they have dissimilar terms.

Term sheets vary greatly from deal to deal and from funder to funder. One term that appears in most term sheets is the return of the invested capital as the first money out. In other words, the funder usually gets back the money it invested in the case before proceeds are shared further between the investor, the patent holder and the law firm, as the case may be. Other terms in term sheets vary, although here are some that appear frequently.

Sharing of recovery based on percentage formula

The sharing of the proceeds between stakeholders may be determined by percentages. For example, the rights holder may receive a certain percentage, while the funder receives the rest. In cases where the law firm has done contingent work and has a backend share, the return is split between the three entities.

The percentages may change over time or as a function of the recovery amount. For example, if a case is resolved early, the rights holder may receive a larger share of the recovery than otherwise. The point that rights holders need to recognise is that the sooner the risk is resolved in a case, the better the economic result for the rights holder. If a case takes longer to resolve, the funder will require a larger portion of the recovery to generate necessary returns on its investment.

Preferred return for funder

Funders may require a certain preferred return in addition to the return of the invested capital. Thus, the funder may receive back the invested amount first and then further receive a certain percentage of the recovery before the rest of the proceeds are shared.

Rights holders would do well to pay attention to whether such a preferred return is compounded annually. If resolution of the case takes a number of years, the compounded interest may well swell to a large sum, increasing the effective cost of capital significantly.

FIGURE 3. Typical due diligence process

Initial funnel	Funder eliminates most cases quickly.	Rights holder should prepare an information package with realistic cost and time estimates.
First level due diligence	Funder carries out due diligence and looks for red flags.	Rights holder should have claim charts and other infringement proofs prepared by legal counsel.
Term sheet	Funder provides a term sheet based on rights holder's assertions and its first level due diligence.	Rights holder should compare term sheets using cost of capital analysis and non-financial considerations.
Detailed due diligence	Funder completes due diligence.	Rights holder and firm should be available along the way – it is key to be forthcoming with information.

Sharing of recovery based on funder's target return

Instead of the proceeds being shared based on agreed percentages, they may be shared based on the dollar amount that the funder needs in order to meet a certain return target. For example, the funder may receive a part of the return that equals the dollar amount corresponding to a target internal rate of return (IRR), and then may receive no further proceeds.

A rights holder should recognise that either this type of a sharing formula or a percentage-based formula, as explained above, may be more advantageous to the rights holder, depending on the size and timing of the recovery. Both scenarios must be evaluated under baseline recovery assumptions.

Multiples of invested capital to funder first

This type of term requires that the funder receive the invested amount plus a multiple of it before any sharing starts. There are cases in which the funder asked to receive two or three times, or even a higher multiple, before sharing begins. Such term sheets are generally not competitive and a rights holder receiving one would be well advised to look for another funder.

Interest paid on invested amount

This is a term that may appear in credit financing deals whereby, in the event of a recovery, the funder receives the invested amount plus a certain percentage interest per year on the invested amount before the rights holder and the law firm participate in the returns. Similar to the preferred return above, a rights holder should determine what the interest amounts to under realistic baseline assumptions before making a decision.

Control and board membership

Term sheets may include provisions that allow the funder to exert control over the rights holder's operational expenses – especially if negative events occur in the course of the legal case. This is generally put in the term sheet to ensure that the rights holder (eg, an operating company with limited resources) will not spend itself into bankruptcy and then be without the reserves to continue to the IP case. A similar thought process applies to board membership clauses. All such control clauses may be present in a term sheet if the invested amount is significant.

Liens on company assets

In secured financing deals the funder may require the rights holder to offer company assets as collateral. In patent cases, the collateral is often the company's patents which are not involved in the ongoing litigation. This is a difficult term indeed. On the one hand, the collateral should afford the rights holder a term sheet where the cost of capital is significantly lower than a non-recourse equity type investment. On the other hand, if the case does not go well, the rights holder loses not only its legal claim, but also the company's valuable assets. For small companies with limited reserves, this may spell the end of the company.

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Calculating cost of capital

Even if a rights holder has a good understanding of the common term sheet items listed above, there is still the task of comparing different term sheets – often not a trivial exercise. For instance, how do you compare term sheets where one asks for a certain multiple of the invested capital and another asks for a certain percentage of the damages recovered? The answer is by reducing each term sheet to its cost of capital.

Since terms will likely include return of the invested capital upfront and some sort of time-dependent component, the patent holder ought to start with a baseline pay-out scenario and calculate the cost of capital. This is easy to do if the funding is in the form of debt. For debt financing with only an interest rate and eventual return of the capital, the cost of capital is the interest rate (perhaps minus the tax advantage, if the interest payment is tax deductible).

Calculating the cost of capital for anything other than pure debt financing in IP litigation funding becomes complicated. Ideally, the fundamental way to value any investment is to use discounted cash-flow (DCF) analysis to calculate the net present value (NPV) of the investment. DCF is simply the present day value of all future cash flows discounted to present day by the appropriate discount rate. However, herein lies the challenge.

It can be difficult to work out the correct discount rate to be used in a particular litigation funding opportunity. In more traditional financing deals outside the IP world, the weighted average cost of capital factors in components of the funding. In those cases the cost of debt is inherent in its terms and therefore known. Similarly, the cost of equity can be calculated easily for publicly traded companies and can also be derived using peer analysis for private companies. Not so for litigation funding. As a result, the best metric to use when comparing term sheets for anything other than pure debt financing is IRR, rather than NPV.

IRR calculation does not involve a weighted average cost of capital or other external parameters as it is the discount rate that makes the present value of the investment zero. However, IRR calculation depends on the timing and size of cash flows. Therefore, having a baseline pay-out scenario that assumes a realistic timeline is absolutely critical. A term sheet may be structured in such a way that it results in a lower IRR if the IP litigation is resolved quickly, but may equate to a much higher IRR if the matter takes a long time to resolve. Hence, an IRR calculation can only be as accurate as the assumptions that go into it. IRR calculation does not reveal an NPV, *per se*, but offers an excellent way to compare alternative term sheets.

Once a baseline scenario (the most likely recovery amount and the most likely timing of recovery) is determined, a patent holder seeking funding should perform a sensitivity analysis to see how the cost of capital changes if the case takes longer than the assumed baseline scenario, or if it costs more in hard costs than planned. One way to remove extreme variability in costs is to require the law firm to cap its fees, either based on litigation stage or for the entire case. Patent holders should include a fee cap in their agreement with the law firm even if they are not seeking funding.

Of course, for many patent holders there are considerations other than the cost of capital. This is particularly true when the patent holder is a publicly traded company. Besides the cost of capital, some of the terms worth highlighting include control, dilution and liens on company assets. For instance, a funder may ask to have a board seat and a say in matters relating to company business, especially if things start to look bleak on the litigation side. The patent holder must decide whether sharing corporate control is an issue that they feel comfortable with.

Another issue that public companies may face is whether the type of investment they are bringing in is dilutive to existing common shareholders – such an equity or convertible investment may be difficult for the board to authorise. A funder may also offer debt financing that will be secured by the company's other assets, often times other patents of the company.

Advice to rights holders seeking litigation funding

1. Think like a litigation funder.
2. Be open and forthcoming with both favourable AND unfavourable information.
3. Select a litigation law firm that is willing to put skin in the game.
4. Have a realistic cost estimate and timeline.
5. Have a realistic damages estimate.
6. Work with a litigation funder who will truly be a partner.

Action plan

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IP litigation is a costly undertaking. Recent changes to the IP laws in the United States, particularly in relation to patents, have introduced increased cost and uncertainty for plaintiffs. As a result, there are few full contingency law firms in business today. Litigation funding fills the need for capital necessary in pursuing legitimate IP claims. However, the terms of funding deals are opaque and vary greatly, making it difficult for rights holders to evaluate term sheets and difficult for funders to produce term sheets that fit every plaintiff.

Rights holders seeking litigation funding can follow a few principles to ensure that they can compare dissimilar term sheets judiciously and to bring more transparency to the process:

- Determine the realistic pay-out amount and timeline, and assume that the case will be litigated to the end when calculating expenses.
- Reduce each term sheet to an implied internal rate of return and thus have a way to compare differing term sheets based on a normalised metric.
- Decide what is acceptable with regard to non-financial terms, such as control, dilution and liens on company assets.
- Select a funding partner which not only is a source of capital, but will also be a partner through ups and downs in the course of litigation.

A patent holder may not be comfortable putting company assets at risk. In the end, the patent holder will have to weigh these types of subjective term, as well as the cost of capital, to pick a financial partner. It is never a single formula. Perhaps more important than any other factor from a patent holder's perspective is to gain a value added investor that will serve as a partner for years to come.

The analysis that a patent holder must carry out to analyse a term sheet is much simpler compared to the analysis required of the funder. Funders must not only come to understand the underlying technology intimately, but must also master the strengths and weaknesses of the merits with respect to infringement and validity, the relevant litigation dynamics and damages scenarios. That analysis – and the corresponding risk assessment – must then be translated to a given term sheet that provides the necessary incentives to all parties involved.

The better that rights holders understand how funders evaluate IP litigation opportunities, the better equipped they will be to select the best term sheet and the best partner. The best chance that a rights holder has of getting friendly financing is by thinking like a funder.

Entity-specific funding options

A key question for rights holders is what type of funding best serves their interests. The answer to that question depends on numerous variables. For plaintiffs needing to assert one or two patents, where there is no ongoing business activity (eg, individual inventors), the only option is non-recourse equity type funding. This is because there is no other asset to offer as collateral, no other cash flow that can cover expenses and no option to issue common shares. There are also no pressing control issues, since the patent holder is 'betting the farm'. The only option is to obtain term sheets from one or more funders and compare the cost of capital. In effect, the lack of options makes the decision simpler.

Below are some of the funding options and the pros and cons of each from the perspective of the rights holder.

If the rights holder has a larger portfolio of IP assets or has an independent revenue stream that can be used as collateral, anything from secured credit financing to non-recourse financing are all options. IP assets that are not in litigation or other company assets, including accounts receivables and product revenues, can be used to secure the debt, thereby reducing the cost of capital in any financing. The rights holder would have to assess whether risking the loss of company assets is an acceptable trade-off.

For publicly traded companies, both equity and credit financing options are viable. However, the thorny issues tend to involve board seats, operational control and liens that the company may have to offer on their IP assets. In the case of equity type funding, the company's balance sheet is protected and the income statement is unaffected by litigation expenses. Moreover, the investment is not dilutive to the common shareholders, which is also a plus. On the flip side, the cost of capital is likely to be higher than what is implied by the company's common shares.

Publicly traded companies also have the option to seek secured or unsecured debt financing for litigation. Debt financing does affect the balance sheet as new liabilities are added; in addition it affects the income statement if there is interest expense associated with the financing.

If the patent holder is a start-up where the value of the company is still far in the future, another possibility is to lower the cost of capital in IP litigation financing by including warrants (or, alternatively, caps on a convertible debt) as part of the deal. Warrants may bring in funders that otherwise would not be interested. In case of convertible debt with a conversion cap, this structure lets the company postpone determining a share price while still rewarding the funder. Of course, warrants are dilutive to other shareholder when exercised.

Think like a litigation funder

For those patent holders seeking IP litigation funding, the single best advice is to think like a litigation funder. In other words, have an understanding of how funders look at opportunities, how they evaluate them and what would make it easy and quick for them to complete their evaluation. The methods and concepts described above are meant to give rights holders an understanding of exactly that. iam

Fatih Ozluturk is a managing principal of Soryn IP Group, New York, United States